KANGANEWS AWARDS 2017
WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

Kapstream
— JANUS HENDERSON —

Monthly Report

# Kapstream Absolute Return Income Fund

## November 2017

| Performance | Month (%) | 3 Months (%) | 1 year (%) | 3 years (%) p.a. | 5 years (%) p.a. | Inception (%) p.a. |
|---|---|---|---|---|---|---|
| Portfolio (gross)[1] | 0.33 | 1.08 | 4.17 | 3.80 | 4.37 | 5.68 |
| 50% Bloomberg AusBond Bank Bill Index & 50% Bloomberg AusBond Composite 0-3 Yr Index | 0.18 | 0.56 | 2.08 | 2.31 | 2.54 | 3.70 |
| **Active return (gross)[2]** | 0.15 | 0.51 | 2.09 | 1.49 | 1.82 | 1.98 |

1. Gross returns exclude impact of ongoing management fees. No allowance is made for tax.
2. Numbers may not add due to rounding
3. Benchmark performance includes the RBA Cash Rate until 31 January 2014.

### Portfolio Commentary

The Fund returned 0.33% before fees and 0.29% after 'I' shareclass fees in November. On the same after fees basis, calendar year to date the Fund has now returned 3.64%. With relatively stable bond markets and the RBA official cash rate holding at 1.5%, we expect to comfortably meet the Fund's full year target of delivering investors a return of between 2% and 3% above cash by year-end. Interest income from the portfolio's bond holdings remained the largest positive contributor to performance over the month, whilst 3.3 years of credit spread duration exposure also aided returns. A long Australian interest rate position versus US interest rates also aided returns as Australian yields continued to fall versus the US. The portfolio's long position in a basket of Asian currencies (THB, SGD and INR) vs. the USD was slightly positive for returns but was offset by a short Euro vs. USD position. The Euro continued its rally amidst stronger European growth prospects.

### Portfolio Strategy

We maintained the portfolio's interest rate duration exposure at approximately +0.4 years (predominantly comprising exposure to US interest rates of -0.10 years and exposure to Australian interest rates of +0.50 years) reflecting our view that near-term US interest rate hikes are likely and as such a neutral or slightly negative exposure is prudent, and in Australia that the RBA is likely to maintain rates for some time yet at current levels. Reflecting our continuing constructive view of corporate health and profitability, we maintained the credit spread duration exposure at 3.3 years. Also reflecting our constructive view, we reduced our 'liquidity bucket' (comprising cash/cash-like/sovereign assets) from ~9% to ~6.5%, buying a number of appealing new issues, predominantly in Australian investment grade credit. We expect to continue to reduce this liquidity bucket to about 6% over the coming month.

### Outlook

US political drama will continue to drive global bond markets over the remainder of the year, but controversy surrounding the healthcare/immigration/tax reform debate and the latest addition/purge in the revolving show circus that has become the White House inner-circle (otherwise known as adult day care) are the smaller of our political concerns. Two of the three branches of US government remain broken. We had expected little from the Republican led Congress on tax reform following failures on healthcare overhaul and immigration. While we are thus far surprised at the progress made on tax reform, we remain pessimistic on the likelihood for it to be comprehensive. In our view tax cuts for the wealthy and corporations are still the likely outcome, but leading to little overall economic benefit. Recent political victories in Congress leave us less pessimistic on US growth into 2018 and we have become more neutral to the almost 2 hikes priced in 2018 (plus 1 in December 2017).

The recent hurricane/floods will provide an estimated US$75 billion boost and could deliver an additional 0.2% to 0.4% growth over the next few quarters. Tax reform is likely to deliver little meaningful economic benefit over 2018. Like US dollar strength, global bond yields will remain a barometer of markets' faith in Trump/the Republican's economic plans. Whilst jobs growth remains mostly robust, wage increases and inflation remain well contained. The US may be close to full employment as strong payrolls data, less job openings and quit rates point to a strong labour market. Nonetheless, inflation remains well contained, as wage inflation remains low, driven by weak labour bargaining power.

Normalization of the Fed's balance sheet will produce only modest tapering. The June statement, indicating initial monthly tapering caps of USD6 billion and USD4 billion for Treasuries and MBS, respectively, peaking at USD30 billion and USD20 billion through progressive quarterly caps, indicate a USD1 trillion taper over the next 3½ years leaving the Fed with a USD3.3 trillion balance sheet.

Nonetheless, we expect the Fed to tread carefully, given Brexit concerns, European banking volatility, slower Asian growth, geopolitical risks and little progress in Trump's economic plans.

While we foresee eventual rises in service sector inflation, goods inflation will remain well contained, being less linked to decreasing US unemployment. Global spare capacity will continue to make cheap imports a viable alternative to domestic products. CYTD payroll gains corroborate the last 7+ years of stable and steady jobs growth, but the story is so far non-inflationary. We expect unemployment to remain close to the current 4.1%, a 16-year low. Wage pressures will eventually become a concern, with average hourly earnings at 2.1% and the ratio of job seekers to number of available jobs moving from 9:1 toward 1:1. But not in the near term. We believe core inflation will remain contained until wage gains move beyond 3%, a level not seen since 2009.

We remain sympathetic to the Fed's Kashkari's belief that recent rate hikes have been "doing real harm" to the US economy, leading to "slower job growth, leaving more people on the sidelines, leading to lower wage growth, lower inflation and lower inflation expectations." Overestimating labour market tightness and its impact on inflation will become a more central theme particularly as Trump appoints another 4 Fed governors over the remainder of his term. This should mean a more dovish Fed for the long-run.

In global bond markets we continue to favour Australian rates versus the rest of the world, particularly as Australian bonds underperformed the US in the 3rd quarter. We expect the Reserve Bank of Australia to remain on hold for the remainder of 2017 and all of 2018. Housing and labour markets will remain key factors in future growth and inflation expectations and we expect the RBA will await further data before acting.

Chinese growth will remain key for Australia and we remain optimistic despite a deceleration in credit provisions. GDP remaining near 6.5%, in line with targets, remains our base case. We expect continuation of an agenda supporting the addition of 10 million people/year into the urban labour force as a central economic policy theme whilst financial sector reforms will remain an important yet secondary policy goal.

Strong Chinese and Asian growth, core inflation reaching 1.8%, employment gains (particularly the recent gains in full-time hiring) and improved terms of trade provide for a solid domestic story. We foresee a continuation of the string of 26 years of recession free growth. However, non-mining investment and a lack of wage growth will cause the RBA to tread carefully. Whilst recent employment gains remain solid, globalization and technology advancements mean wage growth is likely to remain well contained. Averaging 30k/month and 296k YTD through October, jobs gains remain strong and an unemployment rate at 5.4% reconfirm a solid jobs story. Higher participation rates have kept the unemployment rate in the +/-5.5% range since 2009 and we expect a decrease only gradually in the coming years. Nonetheless, weaker household consumption and still heavily indebted consumers will offset much of solid jobs story.

The latest wage data re-confirm weak wage growth at an annualised 2%, near the lowest levels in more than 25 years, suggesting core inflation will likely remain below the RBA's 2% to 3% target. The underemployment rate remains at 8.6%, a near-record high. The need for Australia to become more competitive in a global world, technological change and weaker labour bargaining power will likely continue to keep downward pressure on wages. The impact of macro-prudential policy changes have yet to filter through the economy, but we believe inflation risks will remain to the downside, keeping the RBA on hold well into 2018. While the RBA will tolerate a stronger currency, financial conditions are tightening, limiting the RBA's ability to increase rates. We expect continuing AUD strength leading to further subdued price pressures.

We continue to hold a positive view on investment grade credit in Australia, largely due to:
- attractive real yields
- healthiness of issuers compared to other developed markets
- wider yield spreads versus comparable US, Euro and Japanese issuers

Therefore, our portfolios continue to have material exposure to Australia, currently at about 67% of our holdings. Favoured sectors remain the banking sector due to attractive yields and greater liquidity, and infrastructure such as airports and toll roads which offer attractive yields and solid cashflows, and are typically monopolistic businesses with high regulation and quality underlying collateral, of systemic importance. Whilst Australian banks came under further pressure with the revelation of a new bank tax and rating agency downgrades of 2nd tier banks and 1st tier hybrids, we remain bullish on Australian senior bank debt given conservative business models, strong profitability and implicit government support.

We remain less supportive of European bond opportunities. In the nearer-term, political risks have decreased following the French elections and near-term growth has improved, aided by increased consumer spending and improving employment, but we see little inflationary pressure. We believe the ECB will continue to struggle with the effectiveness of its quantitative easing program, currently at EUR30 billion/month in sovereign and corporate bond purchases. Prospects for a greater QE program later in 2018 are increasing despite market expectations for an eventual end to QE. We expect 2018 European growth and inflation to continue underperform expectations amidst structural rigidities in labour and product markets, particularly in peripheral regions. Low/negative bond yields already reflect this scenario.

Despite low growth, low inflation and easy monetary policy, we have found bond opportunities limited given low/negative yields and too great risks associated with higher-yielding investments. We expect to continue to avoid Europe, given uncertainty surrounding the Brexit campaign, low yields and limited corporate profitability. We are particularly concerned over the European banking sector, which had historically done little in raising new capital or writing down bad debts. While the ECB has the capacity to continue to paper over the problem in the shorter-run, balance sheet expansion will be the likely end result, at least before nationalization of weaker performing banks. This scenario may be many years away. In the interim, we expect more QE, with little growth and inflation prospects in the Southern European region.

Elsewhere, we like systemically important, highly rated Asian issuers such as government-related energy, telecom and banking entities and the US 'too-big-to-fail' banks, whose bonds should be supported by an increasingly robust regulatory environment focused on less risk taking and greater capital requirements.

## Contact Details

Courtney Chute - Portfolio Analyst, Kapstream Capital | Tel 02 9234 0009 | email: Courtney.Chute@kapstream.com